No. 12436

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

PACIFIC MAGNESIUM, INC. (formerly Socal Magnesium, Inc.),

Appellant,

vs.

HARRY C. WESTOVER, Individually and as Collector of Internal Revenue for the Sixth District of California,

Appellee.

BRIEF FOR THE APPELLANT.

PAUL P. O'BRIEN,

Clerk

MELVIN D. WILSON,
810 Title Insurance Building, Los Angeles 13,
Counsel for Appellant.

Parker & Company, Law Printers, Los Angeles. Phone MA. 6-9171.

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TABLE OF AUTHORITIES CITED

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Opinion Below.

The opinion in this case was written by United States District Judge Leon R. Yankwich, and was entered October 18, 1949 [R. 11 to 25, incl.], and is reported as 86 Fed. Supp. 644.

Jurisdiction.

This proceeding involves a suit for recovery of Federal corporate excess profits tax for the appellant's calendar year, 1944, in the amount of $35,365.35 plus interest thereon of six per cent (6%) from November 14, 1947. [R. 6.]

Appellant is a corporation organized under the laws of California, having its principal place of business at 1201

El Vago, La Canada, California. [R. 2.] On March 15, 1945, appellant filed with the appellee, the Collector of Internal Revenue for the Sixth District of California, its income and excess profits tax returns for the calendar year 1944. On October 15, 1947, appellant received from the Commissioner of Internal Revenue, a letter issued under the provisions of Section 272 of the Internal Revenue Code, proposing a deficiency of $36,352.39 in excess profits tax for the calendar year 1944. On November 14, 1947, appellant paid to the appellee, the Collector of Internal Revenue for the Sixth District of California, the $36,352.39 demanded by the Commissioner of Internal Revenue, together with interest thereon amounting to $5,816.38. On March 12, 1948, appellant filed with the appellee its claim for the refund of excess profits tax for the calendar year 1944 in the amount of $30,487.39, plus interest paid thereon in the amount of $4,877.98, plus statutory interest on both of said amounts. The grounds for the claim are the same as are set forth in the complaint and in this appeal. [R. 71 to 76, incl.; 2 to 6, incl.]

Neither the appellee nor the Commissioner of Internal Revenue nor anyone else audited said claim within six months of its filing, and appellant brought suit against the appellee in the United States District Court for the Southern District of California, Central Division. Jurisdiction was conferred on such Court by Section 3772 of the Internal Revenue Code.

Judgment was entered in favor of the appellee and against the appellant on October 31, 1949. [R. 29, 30.]

Within sixty (60) days and on November 30, 1949, Notice of Appeal, Cash Bond, Statement of Points Relied Upon, Designation of Portions of Record on Appeal, and

Condensation of the Testimony of Ralph D. Sweeney, were filed with the Clerk of the District Court, Southern District of California, Central Division. [R. 30 to 39, incl.] Jurisdiction is conferred on your Honorable Court by Section 1291 of Title 28 of the United States Code.

Statement of the Case.

This proceeding is an appeal from the judgment of the District Court of the United States, Southern District of California, Central Division, which determined that appellant was not entitled to a refund of Federal corporate excess profits taxes for the calendar year 1944 in the amount of $35,365.35 plus interest thereon as provided by law.

The question for review is whether appellant realized taxable income in 1944 when a debt in the amount of $39,335.07, owing by it to a corporation called Socal Foundry, was cancelled, appellant paying $4,000.00 to the creditor.

The entire record has been brought up for review. There can be no controversy over the facts, as they were introduced by stipulation and the testimony of one witness, whose testimony did not contradict the stipulated facts.

As of November 20, 1944, one P. H. Sheedy owned all the stock of appellant and all of the stock of another corporation called Socal Foundry. He was president and a director of both companies. [R. 41 and 42.]

The names of the two companies are slightly confusing. Appellant, Pacific Magnesium, Inc., was formerly called "Socal Magnesium, Inc." It will be referred to as "Magnesium Company (appellant)," or as appellant. The other

company, "Socal Foundry," will be referred to as "Foundry."

Magnesium Company (appellant) on November 20, 1944, owed $39,335.07 to Foundry on account of numerous transactions which occurred in 1943 and 1944, wherein Foundry supplied appellant supplies, services and equipment. While appellant had sufficient assets to pay this debt, the payment would require appellant to liquidate its capital assets, as it could not make the payment and continue in business. [R. 32, 33, 54.]

Mr. Sheedy was not well and desired to sell the stock of Foundry to a Mr. Gaines who had formerly been an officer and director of both companies and was familiar with their activities. On November 20, 1944, Frank Gaines was neither an officer nor a director of either company. [R. 42, 43.]

Mr. Sheedy was unwilling to sell the stock of Foundry without eliminating the debt appellant owed Foundry, as he feared that Gaines or a subsequent owner of the stock of Foundry would embarrass appellant and put it into liquidation in an effort to collect the debt owing by appellant to Foundry. [R. 32, 33.]

Accordingly, Mr. Sheedy, as part of the contract to sell the stock of Foundry to Mr. Gaines, stipulated that Foundry should compose its $39,335.07 claim against appellant for $4,000.00. [R. 33, 49.]

This arrangement suited Mr. Gaines very well as he had but a limited amount of money and this would enable him to buy the stock of Foundry for $35,335.07 less than he otherwise would have to pay if Foundry's claim against appellant was to be collected. [R. 33, 34.]

Accordingly, on November 20, 1944, Sheedy and Gaines entered into a contract by the terms of which Sheedy sold the stock of Foundry to Gaines for $42,000.00. [R. 48.] In that contract Sheedy bound Gaines to cause Foundry to compose the $39,335.07 claim against appellant for $4,000.00 and Gaines indemnified Sheedy and appellant against the possibility of paying the remaining $35,335.07. [R. 48, 49.]

This contract, made between Sheedy and Gaines, was for the benefit of a third party, appellant, and it could enforce the contract against Gaines. Said contract, donated to appellant by its sole stockholder, was worth $35,335.07, and appellant realized $35,335.07 therefrom when Mr. Gaines caused Foundry to cancel for nothing the $35,-335.07 debt owing from appellant. [R. 49, 43.]

The contract was executed and immediately carried into effect and on November 20, 1944, Gaines and his nominees were elected to the Board of Directors of Foundry and Sheedy and his nominees retired as directors of that company. [R. 34, 43.] Gaines and his nominees passed a resolution to carry the contribution into effect, as they were required to do. [R. 43, 55.]

The Commissioner of Internal Revenue determined that the $35,335.07 constituted income to appellant, and appellant paid the tax and filed the claim for refund and brought this suit as heretofore stated. [R. 5, 9, 3.]

Appellant's position, in its claim for refund [R. 71] and before the District Court [R. 5] and in this appeal, is that the forgiveness of its debt by Foundry was a non-taxable gift from Foundry to appellant or was, in effect, a contribution of capital by appellant's sole stockholder, Mr. Sheedy, and in any event, was not taxable income to appellant.

Statute and Regulations Involved.

The statute involved is Section 22 of the Internal Revenue Code which in material part reads as follows:

> "Section 22(a). General Definition.—'Gross income' includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including personal service as an officer or employee of a State, or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. . . .
>
> (b) Exclusions from Gross Income.—The following items shall not be included in gross income and shall be exempt from taxation under this chapter:
>
> (3) The value of the property acquired by gift, bequest, device or inheritance. . . ."

Regulation 111, Section 29.22(a)-13, reads in part as follows:

> "Cancellation of indebtedness.—(a) In general.—The cancellation of indebtedness, in whole or in part, may result in the realization of income. If, for example, an individual performs services for a creditor,

who in consideration thereof cancels the debt, income in the amount of the debt is realized by the debtor as compensation for his services. A taxpayer realizes income by the payment or purchase of his obligations at less than their face value. In general, if a shareholder in a corporation which is indebted to him gratuitously forgives the debt, the transaction amounts to a contribution to the capital of the corporation to the extent of the principal of the debt."

Regulation 111, Section 29.22(a)-16, reads as follows:

"Contributions to corporation by shareholders.—If a corporation requires additional funds for conducting its business and obtains such needed money through voluntary pro rata payments by its shareholders, the amounts so received being credited to its surplus account or to a special capital account, such amounts will not be considered income, although there is no increase in the outstanding shares of stock of the corporation. The payments under such circumstances are in the nature of voluntary assessments upon, and represent an additional price paid for, the shares of stock held by the individual shareholders, and will be treated as an addition to and as a part of the operating capital of the company."

Specification of Errors.

The District Court of the United States erred:

1. In failing to find that Foundry intended to and did make a gift to appellant of $35,335.07 on November 20, 1944, by settling the claim of $39,335.07 of Foundry against appellant for $4,000.00, and that such gift was to be excluded from appellant's gross income under the provisions of Section 22(b)(3) of the Internal Revenue Code.

2. In failing to find that P. H. Sheedy, appellant's sole stockholder, made a contribution to appellant's capital of $35,335.07 on November 20, 1944, and that such contribution to capital by the stockholder was not income to appellant.

3. In finding that appellant realized $35,335.07 taxable income out of a transaction on November 20, 1944, wherein a debt of $35,335.07 was forgiven.

4. In rendering judgment for appellee on the facts found. [R. 37, 38.]

ARGUMENT.

I.

Summary of Argument.

The appellant contends that the forgiveness of the indebtedness does not constitute income to it, for either of two reasons.

First, that Foundry intended to benefit appellant to the extent of $35,335.07 and that this amount constituted a gift from Foundry to appellant, and hence is not income under Section 22(b)(3) of the Internal Revenue Code.

P. H. Sheedy owned all of the stock of Foundry and was its president and a director. Its other directors were his nominees or "dummies" and subject to his control. At a time while those conditions obtained, Mr. Sheedy determined to benefit appellant to the extent of $35,335.07 by having Foundry forgive the $35,335.07 debt owing from appellant to Foundry. Mr. Sheedy's intentions and desires necessarily constituted the intentions and desires of Foundry, as he could work his will upon that company. Foundry, therefore, through its sole stockholder, president and director, Mr. Sheedy, determined to benefit appellant to the extent of $35,335.07, and the forgiveness of the $35,335.07 debt was a gift, and not income, to appellant.

Instead of carrying out this intention and desire while in office, Mr. Sheedy entered into a binding contract which required the purchaser of Foundry stock to carry out such plan. The purchaser, Mr. Gaines, necessarily had to carry out such plan as he had agreed to do so, and had indemnified Mr. Sheedy and appellant against the $35,335.07 debt.

Mr. Sheedy intended to cause Foundry to make a gift to appellant and required that his buyer cause it to do so. Hence the forgiveness by Foundry was a gift made with the intention of benefiting appellant and is not taxable.

Second, Mr. Sheedy made a capital contribution to appellant of $35,335.07, and capital contribution made by a sole stockholder is not income.

Mr. Sheedy owned all the stock of appellant and of Foundry. In an economic and practical sense they were his instruments, his tools, his agents, his property.

Mr. Sheedy desired to take some property out of Foundry and put it into appellant. This he did by requiring Gaines to cause Foundry to cancel $35,335.07 of appellant's debt, and this constitutes a capital contribution to appellant from its sole stockholder, Mr. Sheedy. Capital contributions are not income, and hence the capital contribution made by Mr. Sheedy in the form of forgiveness of the debt owing Foundry is not taxable income to appellant.

Looking at the matter from a different position, it is clear that Mr. Sheedy, appellant's sole stockholder, by his contract with Mr. Gaines, made a direct contribution to appellant of a right, enforceable by it, to require Gaines to cause appellant's debt of $35,335.07 to be cancelled without consideration flowing from appellant. Mr. Sheedy made a contract for the benefit of appellant, a third person, which contract was worth $35,335.07, and this amounts to a direct capital contribution to appellant from its sole stockholder, and is not taxable income.

II.

The Court Erred in Failing to Find That Foundry Intended to and Did Make a Gift to Appellant of $35,335.07 on November 20, 1944, by Settling the Claim of $39,335.07 of Foundry Against Appellant, for $4,000.00.

In *Commissioner v. Jacobson,* 336 U. S. 28, the Supreme Court, in its latest consideration of the type of question involved in the case at bar, said:

> "The situation in each transaction is a factual one. It turns upon whether the transaction is in fact a transfer of something for the best price available or is a transfer or release of only a part of a claim for cash and of the balance 'for nothing.' The latter situation is more likely to arise in connection with a release of an open account for rent or for interest, as was found to have occurred in *Helvering v. American Dental Company, supra,* than in the sale of outstanding securities, either of a corporation as described in Section 22(b)(9), or of a natural person as presented in this case."

A recent example of a release "for nothing" is seen in *Boos v. Reynolds,* 84 F. 2d 185, where the lessor told the lessee to "forget" the back rent, and the court held that this was a gift to the lessee, and not income.

In the case at bar, it is believed that the evidence shows that Foundry transferred $4,000.00 of the open account for $4,000.00 cash, and $35,335.07 of the open account "for nothing," and that the latter was a non-taxable gift to appellant.

The trial court in the case at bar decided erroneously that Foundry did not make a gift to appellant of the $35,335.07 for the following reasons:

1. That there can be no gift if there was any consideration flowing from the alleged donee, and here appellant paid $4,000.00 to the creditor. [R. 19.]

2. That Gaines' views of the transaction would control rather than Sheedy's views. [R. 20, 21.]

3. That the form of the resolution adopted by Foundry's new Board of Directors and the writing off of the debt in its tax returns as a loss, indicated that no gift was intended. [R. 21.]

As to the first point, that there can be no gift if there is consideration from the alleged donee, the decision of the Supreme Court in *Helvering v. American Dental Company,* 318 U. S. 322, is directly to the contrary. In that case the debtor owed back rent amounting to $15,298.99. The creditor accepted $7,500.00 in payment of the $15,298.99 debt and cancelled the remainder. Though in form this settlement was a compromise, the Supreme Court held that the forgiveness was gratuitous, the release of something to the debtor for nothing, and that the cancellation was a gift under Section 22(b)(3) of the Internal Revenue Code, and hence not taxable income to the debtor.

Furthermore, the Supreme Court in *Commissioner v. Jacobson,* 336 U. S. 28, again recognized, as shown by the quotation from that decision on page 11 of this brief, that in one transaction there might be a transfer of part of an open account for cash, and a release of the balance "for nothing," and that the latter would be a non-taxable gift.

It is otherwise clear that a single transaction can have two elements. For example, suppose that a father settled for $1,000.00, a $10,000.00 debt owing him from his solvent son. Though the transaction appeared to be a compromise in form, the $9,000.00 would undoubtedly be treated as a gift, both for Federal Income Tax purposes and for Federal Gift Tax purposes. In Section 1002 of the Internal Revenue Code defining "gifts," for the purpose of the Gift Tax, the following appears:

> "Where property is transferred for less than adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration shall, for the purpose of the tax imposed by this chapter, be deemed a gift, and shall be included in computing the amount of gifts made during the taxable year."

While the Income Tax Law excludes gifts from gross income, it does not define them. The Gift Tax Law defines the word "gift" in considerable detail and the above quotation shows that a transaction can be part purchase, but still the value of the property transferred in excess of the consideration paid by the transferee, is a gift. That was the situation in *Helvering v. American Dental Company,* 318 U. S. 322, *supra,* discussed above, and the situation recognized in *Commissioner v. Jacobson,* 336 U. S. 28.

Consequently, the fact that Mr. Sheedy decided that the appellant, in the case at bar, would pay $4,000.00 on account of its $39,335.07 debt, does not characterize the entire transaction as an arm's length transaction, nor indicate that the creditor, Foundry, was obtaining all it could get, but leaves the question open for further con-

sideration as to whether the creditor really intended to make a gift to the debtor of the balance.

Coming to the trial court's second error, the testimony of Mr. Sweeney, Sheedy's attorney (Mr. Sheedy being dead), shows that Mr. Sheedy wanted to improve the financial condition of appellant so that it could not be embarrassed by its creditors. [R. 32, 33.] This same donative intent was imputed to Foundry. [R. 34.]

Foundry, at the time this transaction was contracted, was wholly owned by Mr. Sheedy. [R. 42.] He owned all the stock and was the president and one of the directors of the company and necessarily controlled its every thought and action. [R. 42.] When he desired that appellant be benefited by a cancellation of the debt, Foundry had the same desire and intent and could have no other.

Instead of directly carrying out his benign purpose of benefiting appellant, Mr. Sheedy arranged it so that it would necessarily be carried out. He entered into a binding contract to the effect that Foundry would forgive some of the debt owing to it by appellant. [R. 49.]

All the parties to the contract knew that appellant had sufficient assets to pay its debt, if such assets were turned into cash, and that it could have paid Foundry the entire $39,335.07. [R. 54, 15.] Consequently, when appellant paid $4,000.00 to Foundry on the $39,335.07 debt, it was not paying all it could pay. The cancellation of the $35,335.07 debt was a gratuity to appellant from Foundry, at the instance of Mr. Sheedy. Mr. Sheedy and hence Foundry, wished to improve appellant's financial condition to the extent of $35,335.07. [R. 32, 33.] Therefore, Foundry did not intend to collect from appellant all that it could collect. [R. 34.] Foundry knew that it could

collect the entire $39,335.07 from appellant, but chose not to do so. It chose not to do so because its sole stockholder, Mr. Sheedy, chose not to do so. [R. 34.]

The court below seems to imply that Foundry could have an intention and a purpose different from that of its sole stockholder, president and director. It brings out the fact that there were two corporations involved and that they are separate entities from the stockholders, for tax purposes. [R. 16, 17.] This, of course, is true, but it does not take any citation of law to establish the fact that a corporation which is wholly owned by one man who is its president and director, is necessarily dominated by that man and must necessarily do his will, and do nothing but his will.

It is abundantly clear that Mr. Sheedy wished to improve appellant's financial condition—wished to increase its net worth by $35,335.07. He accomplished this by having Foundry make the gift or contribution to appellant. Mr. Sheedy, having the power to do so, bound Foundry, through its new owner, Mr. Gaines, to make the contribution or gift to appellant of $35,335.07.

Foundry was a separate corporation and appellant is not attempting to disregard its separate legal entity, but a corporation is simply a legal fiction, not a living, thinking, human being. It *must* act through its stockholders, officers and directors, and can not act otherwise. If all of its stock is owned by one man, who is the president and a director of the company, he necessarily dominates the other directors, who are his nominees, or "dummies," and they and the corporation must do as he pleases, and the corporation's every intention, purpose and desire springs from him.

Consequently, Foundry could not possibly have any intention other than the intention given to it by its sole stockholder, president and director.

We come now to the third point on which the lower court erred. It seems to think that Foundry has shown, by the form of the resolution forgiving the debt, and its action in taking a bad debt deduction on its income tax return, that it attempted to get all from appellant that it could collect. In other words the court thought that Foundry got its intention and purpose from Mr. Gaines and not from Mr. Sheedy. [R. 20, 21.]

It is obvious from the facts that the control and ownership of Foundry changed on November 20, 1944, from Mr. Sheedy to Mr. Frank Gaines. [R. 43.] It is obvious too, from the contract of November 20, 1944 [R. 49], that Mr. Sheedy required Foundry, through his contract with Mr. Gaines, to forgive $35,335.07 of the debt owing by appellant. When Foundry eventually carried that act out through the resolution adopted by Mr. Gaines and his nominees, it was carrying out a direction given to it by Mr. Sheedy, and its purpose and intent in carrying it out, derived from Mr. Sheedy and not from Mr. Gaines. [R. 34, 55.]

It is clear too, that Mr. Sheedy's purpose in causing Foundry to forgive $35,335.07 of the debt was to benefit appellant. He caused Foundry to give appellant $35,335.07 without consideration and merely to benefit appellant. [R. 32, 33.] Such benefit came to appellant gratuitously from Mr. Sheedy and Foundry.

Now the trial court brought out that the moment Mr. Gaines came into the picture, he not only caused Foundry to carry out the forgiveness, as he was bound to do, but

that he may have had a further idea in mind which he then proceeded to carry out, as the contract with Mr. Sheedy did not prohibit him from so doing. In other words, he may have intended that Foundry would attempt to take a bad debt deduction on its income tax returns and that plan may have dictated the form of the language in the resolution cancelling the debt wherein it said:

> "Whereas, it is the belief of the directors of this corporation that said Socal Magnesium, Inc. is unable to pay its said debt and if this corporation can obtain the sum of $4,000.00 from said Socal Magnesium, Inc. in payment of said debt, that it would be a wise and proper thing to do." [R. 55.]

It might appear, therefore, that Foundry changed from a benign, generous Dr. Jekyll, as represented by Mr. Sheedy's intention, to a grasping and scheming Mr. Hyde, represented by Mr. Gaines' desires. Mr. Sheedy, of course, had nothing to do with Foundry after he had disposed of its stock, except to enforce his contract with Gaines.

Stated differently, Foundry, to the extent dominated by Mr. Sheedy, desired to make a gift to appellant. That much is clear. On the other hand, Foundry, if and to the extent dominated by Mr. Gaines in the transaction, desired to treat the forgiveness as a bad debt, deductible on the income tax return. If Mr. Gaines had not been bound by the contract, he would have insisted that appellant pay the entire debt to Foundry. Gaines would not have been satisfied with an attempt to get a bad debt deduction.

The question then remains—which sole stockholder of Foundry controlled for the purpose of the forgiveness and of this case?

The court below apparently holds that Mr. Gaines' intent governed, as the court indicated that Foundry was effecting an accord and satisfaction and getting all it could for a claim of an uncertain amount, and the balance of its claim was a bad debt, deductible on its tax return. [R. 20, 21.] The lower court was inconsistent, as it stated that appellant was able to pay the debt in full. [R. 15.] Since appellant was able to pay the debt in full, Foundry could not possibly have had a bad debt, as a bad debt is one which is uncollectible and worthless. If Foundry's claim against appellant was uncollectible, then it follows that appellant was insolvent, before and after the cancellation, and hence realized no income from the cancellation.

Lakeland Grocery Company, 36 B. T. A. 289;

Haden Company, Memorandum B. T. A., decided 10/20/29, aff'd 118 F. 2d 285, certiorari denied.

Appellant claims that Foundry could have collected all that was owing to it from appellant and this is shown by the balance sheet [R. 54] and by the statement of the court below [R. 15], which is believed to be correct, that both before and after the cancellation of the debt, appellant was solvent. It was solvent beforehand and, therefore, could have fully paid its debt to Foundry.

Furthermore, the Stipulation specifically states that appellant owed Foundry $39,335.07 on open account as of November 20, 1944. Since P. H. Sheedy owned both corporations, how could there be any doubt about the amount of the claim owing from appellant to Foundry? There certainly could not be any dispute about it and the Stipulation [R. 43] shows that the debt was specifically owing in that amount. Therefore, it was not a claim for an

uncertain amount, as the trial court stated [R. 20], but was an account for $39,335.07.

The court below erred in concluding that Foundry was in a legal position on November 20, 1944, to endeavor to collect more than $4,000.00 from appellant. [R. 20.] The court erred in concluding that Foundry had the right to attempt to collect the entire debt, but having realized that no more could be collected from appellant, chose to receive the $4,000.00 as a compromise or as an accord and satisfaction. [R. 20.]

This is entirely unrealistic, as Foundry was not a free agent. If it had been, it could and would have collected the entire amount of the debt. [R. 15.] It was bound by Mr. Sheedy to forgive $35,335.07 of the debt. It had no opportunity to attempt to collect more than $4,000.00 and no opportunity to get all that it could. It was required by Mr. Sheedy to make a gift or contribution to appellant of a collectible, certain debt. [R. 49.]

The situation may be compared with one where A has a house worth $25,000.00 and furniture worth $10,000.00. B is desirous of buying the house and furniture, but A wants the furniture for his son who has just married, so A and B enter into an agreement whereby A sells the house and furniture to B for $25,001.00 with the further agreement that B will sell the furniture to A's son for $1.00. Now if this transaction is carried out in that form, would it be fair to question B's sagacity as a business man and state that he sold furniture worth $10,000.00 for $1.00? It is obvious that B had no opportunity to sell that furniture for its full value. For some reason he came into ownership of the furniture but subject to a condition, namely, that he sell it for $1.00 to a certain person.

Similarly, Foundry, momentarily after the execution of the contract between Messrs. Sheedy and Gaines, had on its books an account receivable against appellant for $39,335.07, but Foundry was not a free agent to collect that fully collectible item. By a contract made between the persons who successively owned all of its stock it was bound to forgive $35,335.07 of the debt. Under these circumstances, could anyone say that Foundry collected all that was otherwise collectible? Could anyone say that Foundry suffered a bad debt loss of $35,335.07? Could anyone say that Mr. Gaines really expected or had an opportunity to collect for Foundry and hence, for himself, the additional $35,335.07 owing from appellant? Could anyone say that Foundry and appellant, after the sale of Foundry's stock to Gaines, negotiated for the settlement of the debt?

The obvious answers to these questions bring out the true situation; that Mr. Sheedy, while in control of Foundry, caused it to forgive a debt owing by appellant, for the purpose of benefiting appellant, and this forgiveness, made for that purpose, was a gift by Foundry, which purpose generated from its sole stockholder. The fact that the transaction was not completely carried out until the moment after Mr. Sheedy had executed the contract and turned over the stock to Mr. Gaines, is immaterial. He bound Mr. Gaines and hence, Foundry, to his purpose of making the gift from Foundry to appellant.

Since the forgiveness by Foundry to appellant was gratuitous and made for the purpose of benefiting appellant, it amounted to a gift, and hence the transaction is non-taxable under Section 22(b)(3) of the Internal Revenue Code.

III.

The Court Erred in Failing to Find That P. H. Sheedy, Appellant's Sole Stockholder, Made a Contribution to Plaintiff's Capital of $35,335.07 on November 20, 1944.

The facts show that appellant could have paid its full debt to Foundry, but it would have had to liquidate its capital assets to do so. [R. 54, 15.] Mr. Sheedy wished it to continue in business and to keep its capital assets for that purpose, so he caused to be donated to it additional capital of $35,335.07 in the form of a forgiveness of indebtedness by Foundry. [R. 32, 33.]

Within the meaning of the word "gift" as found in the Income Tax Statute, Mr. Sheedy made a gift to appellant of $35,335.07.

In Regulation 108, Section 86.2 of the Internal Revenue Code relating to the Gift Tax, appears the following definition of gifts:

> "In the following examples of some transactions resulting in taxable gifts, it will be understood that the transfers were not made for an adequate and full consideration in money or money's worth: 1. Transfer of property by a corporation to B is a gift to the latter from the stockholders of the corporation. If B himself is a stockholder, the transfer, not being a distribution from earnings or in liquidation to which B is entitled as a stockholder, is a gift to him from the other stockholders."

In *Robert H. Scanlon,* 42 B. T. A. 997, it was held that a voluntary contribution by a sole stockholder, to the corporation, was not a taxable gift, because he alone was benefited.

In other words, where corporations are donors or donees of gifts, the realities are considered for gift tax purposes, and the stockholders are treated as the real donors and donees.

Suppose that Mr. Sheedy had owned all the stock of Foundry, but his children had owned all the stock of appellant. If then Mr. Sheedy had caused Foundry to gratuitously forgive the $35,335.07 debt owing by appellant, this would have amounted to a gift from Mr. Sheedy to his children and such gift would have been subject to gift tax.

Looking at the realities of the situation in the case at bar, Mr. Sheedy made a gift to appellant by causing his creature, Socal Foundry, to make that gift.

A gratuitous cancellation by a stockholder of a corporate debt owing to the stockholder is a contribution to its capital and, of course, not income. The Regulation 111, Section 29.22(a)(13), promulgated in connection with the income tax, reads in part as follows:

> "In general, if a shareholder in a corporation which is indebted to him gratuitously forgives the debt, the transaction amounts to a contribution to the capital of the corporation to the extent of the principal of the debt."

This principle has been recognized by a number of courts. In *Carroll-McCreary & Company, Inc., v. Commissioner,* 124 F. 2d 203, the cancellation by stockholder-officers of unpaid salaries was held to be a contribution to the capital of the company and not income to it. In *Commissioner v. Auto-Strop Safety Razor Company, Inc.,* 74 F. 2d 226, the creditor corporation which was the sole stockholder of the debtor corporation, forgave the debt in

order to improve the financial condition of its subsidiary. The court held that the forgiveness did not constitute income to the debtor, even though the debtor had deducted and obtained tax benefits when the debt was accruing as royalties and interest payable to the creditor. In the matter of the *Tripple Z Products, Inc.,* decided on September 9, 1940, by the United States District Court, Southern District of New York, In Bankruptcy, No. 61,868, salaries for the year 1933 were forgiven in 1934 by the two officers who were the only stockholders of the company. The forgiveness of the debt was held not to be income to the corporation. There again the corporation had deducted the salaries and had enjoyed the tax benefit, but this was held to be immaterial. The court also held as immaterial the fact that the creditor's stock in the debtor was increased in value by the forgiveness, the court deciding that this was not a consideration moving to the creditor. It was simply an additional investment by the stockholders in the company.

In *George Hall Corporation,* 2 T. C. 146, a cancellation of interest owing to a large stockholder was held to be not income to the corporation.

In a number of other cases corporate debts to stockholders were gratuitously cancelled and the cancellation was treated as contributions to the capital of the corporations and not taxable income. See:

The Midland Tailors, Paragraph 43,292, Prentice Hall Memorandum Tax Court Service;

Tanner Manufacturing Company, Paragraph 43,-299, Prentice Hall Memorandum Tax Court Service;

S. H. DeRoy & Company, Paragraph 44,154, Prentice Hall Memorandum Tax Court Service.

In *Brown Cab Company,* Paragraph 43,263, Prentice Hall Memorandum Tax Court Service, the Cab Company owed money to Mr. Brown, the sole stockholder, and also owed money to the Brown Transfer Company, which likewise was solely owned by Mr. Brown. Mr. Brown cancelled his claim against the Cab Company and caused the Transfer Company to cancel its claim against the Cab Company. The Tax Court, relying on *Helvering v. American Dental Company,* 318 U. S. 322, held that the Cab Company did not realize taxable income from either of these cancellations. There is a great deal of similarity between the facts of that case and the facts in the case at bar. In both cases the sole stockholder of the debtor and creditor corporations caused the creditor corporation to forgive an inter-company debt.

In *U. S. v. Oregon-Washington Railroad & Navigation Company,* 251 Fed. 211, the cancellation of a debt owing to a sole stockholder was held an increase of capital and not income. Other cases holding that the cancellation of a debt by a stockholder was a gift to the corporation and not income, follow:

Smith Insurance Service, Inc., 9 B. T. A. 284;

Chenango Textile Corporation v. Commissioner, 148 F. 2d 296.

It is obvious, therefore, that Mr. Sheedy indirectly made a contribution to the capital of appellant.

The court below concluded that the cancellation of the indebtedness was not a capital contribution by appellant's sole stockholder, for the reason that Sheedy was that stockholder, but Foundry was the creditor, and their separateness could not be ignored. [R. 16, 17, 18.]

But the lower court has overlooked a most important point.

The contract between Sheedy and Gaines specifically provides that Gaines will "save and hold—Socal Magnesium, Inc. (now Pacific Magnesium Inc.) . . . wholly and completely harmless from any and all liability, claims or demands of whatsoever nature arising from or which may accrue to or be asserted against Socal Magnesium, Inc. by reason of said compromise and settlement of said claim." [R. 49.]

Under Section 1559 of the California Civil Code, "A contract, made expressly for the benefit of a third person, may be enforced by him at any time before the parties thereto rescind it." That has long been the law in California.

17 C. J. S. 1121, 1122.

In other words, Sheedy made a contract for the benefit of appellant, a contract appellant could enforce, a contract worth $35,335.07 to appellant. Mr. Sheedy, the sole stockholder of appellant, did this, not Foundry. He delivered to appellant an enforceable contract, by which appellant could force a solvent individual, Mr. Gaines, to pay or cause to be cancelled, appellant's $35,335.07 debt to a creditor, Foundry. Appellant realized a $35,335.07 benefit from this gift by Sheedy. The effect of this contract was similar to a gift of $35,335.07 cash directly from Sheedy to appellant.

Consequently, the lower court was in error when it concluded that the contribution was not from the sole stockholder. The court was in error when it concluded that the "contribution" was made by Foundry, while domi-

nated by Gaines, and was an accord and satisfaction for all that Foundry could get.

Regulation 111, Section 29.22(a)-16, as quoted on page 22 of this brief, shows that a contribution to the capital of a corporation by a stockholder is not income to the company.

IV.

The Court Erred in Holding That the Cancellation of Indebtedness Constituted Taxable Income to Appellant.

In the second section of this brief it was shown that Foundry had an intention and purpose, which generated from its sole stockholder, Mr. Sheedy, to gratuitously forgive a collectible debt due from appellant, for the purpose of benefiting appellant, and that this benefit to appellant was a gift to it and not subject to income tax under the statute.

In the third section of the brief it is shown that in the alternative, Mr. Sheedy made a gift to appellant as a contribution to its capital, by causing the creditor to cancel a debt. The regulations and decided cases show that a gratuitous forgiveness of a debt owing by a corporation to a shareholder is a contribution to its capital and is not income.

Another way of looking at Mr. Sheedy's contribution to appellant is to note that the sole stockholder, Mr. Sheedy, directly donated to appellant a right or chose in action entitling appellant to enforce a direct benefit from Mr. Gaines, to the extent of $35,335.07. Appellant realized $35,335.07 from this contribution from its sole stockholder, Mr. Sheedy, by having its debt of $35,335.07 to Foundry cancelled without consideration.

Under this facet of the transaction, appellant received a capital contribution directly from its sole stockholder, which, under Regulation 111, Section 29.22(a)-16, quoted on page 22 of this brief, was not income to appellant.

It would not be inequitable to the Government to rule that this cancellation constituted a gift to appellant, not subject to income tax. While Foundry, under the guidance of Mr. Gaines, attempted to get a tax benefit out of the cancellation, it availed it nothing and the Government did not lose any revenue through the deduction by Foundry. Neither Mr. Sheedy nor appellant had anything to do with this matter. Consequently, there is no occasion for straining a point to protect the Government against an injustice, but on the contrary, it would be an injustice to tax appellant on this transaction, as it was a gift from Foundry or a capital contribution from Mr. Sheedy. While there was no tax benefit to Foundry here, the cases show that the existence of a tax benefit to either party to the transaction is immaterial. In *Helvering v. American Dental Company,* 318 U. S. 322, the debtor had accrued and deducted the interest and rent in prior years and had received a tax benefit. Nevertheless, when the unpaid interest and rent was forgiven, the Supreme Court held that this did not constitute taxable income.

In the case at bar the debt was an open book account which is not ordinarily the subject of sale between parties. Furthermore, both the creditor and the debtor were, in this case, owned by the same man, who negotiated with himself in making this cancellation. In parting with control of

the creditor company, he required its new owner to forgive the debt, so that the creditor corporation never had an opportunity to collect more than the $4,000.00, but was required to make a gratuitous cancellation of a collectible debt. This was not a bad debt, but a gift.

Conclusion.

Appellant contends that the District Court clearly erred in treating the $35,335.07 item as taxable income to appellant and the decision should be reversed on this point.

Dated at Los Angeles, California, on this 23rd day of February, 1950.

Respectfully submitted,

MELVIN D. WILSON,

Counsel for Appellant.